Internal Revenue Service

Department of the Treasury

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Date: SEP 29 1998

Parent =

Sub =

FSC =

State A =

Country A =

Country B =

C business =

Dear

This letter responds to your initial correspondence dated November, 14, 1997, and supplemental correspondence. Specifically, you requested a ruling on behalf of the above-referenced taxpayer as to the federal income tax consequences of a proposed transaction.

The information submitted indicates that Parent, a State A corporation, is the common parent of a consolidated group. Parent files its return on a calendar year basis and utilizes the accrual method of accounting. Parent is engaged in C business.

To facilitate its export sales, Parent formed FSC, a foreign corporation that has elected and qualifies for treatment as a foreign sales corporation under § 927(f) of the Internal Revenue Code. FSC was incorporated under the laws of Country A, but later changed its country of incorporation to Country B. Parent has represented that it and its FSC have a valid related

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supplier agreement under which FSC is a commission foreign sales corporation for Parent's export sales.

For valid business reasons, Parent will form a U.S. subsidiary (Sub) by contributing certain intangibles to Sub, in exchange for all of Sub stock. Parent will enter into a written agreement under which, in consideration for the use of the certain intangibles, Parent will pay Sub an arm's length royalty. These intangibles will be used by Parent in the United States in connection with the manufacturing and selling of certain products, including products subject to the foreign sales corporation commission.

A portion of Parent's royalty payment expense to Sub is required to be allocated and apportioned to the foreign trading gross receipts of the FSC in computing the combined taxable income of the Parent and the FSC pursuant to § 1.925(a)-1T(c)(6) of the Income Tax Regulations. There is no corresponding requirement to allocate and apportion a portion of Sub's royalty income for purposes of computing combined taxable income of the FSC and its related supplier under § 925 and the regulations thereunder. Parent has requested a ruling that a portion of Sub's royalty income be redetermined as foreign trading gross receipts under § 1.1502-13(c)(4)(i)(A).

Section 1.861-8(b) provides that for purposes of computing taxable income from sources within the United States and from other sources and activities, the gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items of gross income and require that the deduction be allocated to such class. Allocation is accomplished by determining with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income.

Section 1.861-8(f)(1) lists the operative sections that require the determination of taxable income from specific sources or activities and give rise to statutory groupings. The determination of the deductions of related suppliers to be taken into account in computing FSC combined taxable income is one of the listed operative sections.

Section 1.861-14T provides special rules for allocating and apportioning expenses other than interest that are not directly allocable and apportionable to any specific income producing activity or property.

Section 1.925(a)-1T(c)(6) provides that for purposes of section 925 and this section of the regulations, if a FSC is the principal on the sale of export property, the full costing combined taxable income of the FSC and its related supplier from the sale is the excess of the foreign trading gross receipts of

the FSC over the total costs of the FSC and related supplier including the related supplier's cost of goods sold and its noninventoriable costs which relate to the foreign trading gross receipts. Interest or carrying charges with respect to the sale are not foreign trading gross receipts.

Section 1.925(a)-1T(c)(6)(iii) provides rules for the determination of gross receipts and total costs. In determining total costs, § 1.925(a)-1T(c)(6)(iii)(D) provides that the costs (other than costs of goods sold) which shall be treated as relating to gross receipts from the sale of export property are the expenses, losses, and deductions definitely related, and therefore allocated and apportioned thereto, and a ratable part of any other expenses, losses, or deductions which are not definitely related to any class of gross income, determined in a manner consistent with the rules set forth in § 1.861-8.

Section 1.1502-13(b)(1)(i) provides that an intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction.

Section 1.1502-13(b)(2) provides generally that a selling member's income, gain, deduction, and loss from an intercompany transaction are its intercompany items.

Section 1.1502-13(b)(3) provides generally that the buying member's income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items.

Section 1.1502-13(a) provides rules for taking into account items of income, gain, deduction, and loss of consolidated group members from intercompany transactions. These rules ensure the clear reflection of the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).

Section 1.1502-13(a)(2) provides that the amount and location of one member's intercompany items and another member's corresponding items are determined on a separate entity basis (separate entity treatment). It also provides that the timing, character, source, and other attributes of the intercompany items and corresponding items, although initially determined on a separate entity basis, are redetermined under this section to produce the effect of transactions between divisions of a single corporation (single entity treatment).

Section 1.1502-13(a)(6) provides, further, that the principal rules of this section that implement single entity treatment are the matching and the acceleration rules found in sections (c) and (d), respectively. Under the matching rule,

the members engaging in an intercompany transaction are generally treated as divisions of a single corporation for purposes of taking into account their items from the intercompany transaction.

Section 1.1502-13(b)(6) provides that the attributes of an intercompany item or corresponding item are all of the item's characteristics, except amount, location, and timing, necessary to determine the item's effect on taxable income (and tax liability). Examples provided in this section include, character, source, treatment as excluded from gross income or as a noncapital, nondeductible amount, and treatment as built-in gain or loss under section 382(h) or 384.

Section 1.1502-13(c)(1) provides that the separate entity attributes of the member's intercompany items and the other member's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if the members were divisions of a single corporation, and the intercompany transaction constituted a transaction between those divisions.

Section 1.1502-13(c)(4) provides special rules for redetermining and allocating attributes under § 1.1502-13(c)(1)(i).

Section 1.1502-13(c)(4)(i)(A) provides generally that to the extent the buying member's corresponding item offsets the selling member's intercompany item in amount, the attributes of the other member's corresponding item, determined based on both members' activities, control the attributes of the member's offsetting intercompany item.

Section 1.1502-13(c)(3) provides that as divisions of a single corporation, the members are treated as engaging in their actual transactions and owning any actual property involved in the transaction (rather than treating the transactions as not occurring).

In the instant case, Parent's licensing of intangibles from Sub to which it pays a royalty payment is an intercompany transaction. Sub is a member providing services, and Parent is the recipient of those services. Section 1.1502-13(c)(1) provides a matching rule under which the separate entity attributes of Sub's intercompany item and Parent's corresponding item are redetermined to produce the same effect on consolidated taxable income as if Sub and Parent were divisions of a single corporation. Treating a portion of the royalty payment expense as a cost of producing Parent's foreign trading gross receipts combined taxable income, the expense reduces Parent's commission deduction (and thus the group's consolidated taxable income is higher). See § 1.925(a)-1T(c)(6). Had Parent and Sub been divisions of a single entity there would not have been a royalty

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payment expense to allocate and apportion, and Parent's commission deduction would have been higher (and the group's consolidated income lower). See § 1.925(a)-1T(c)(6)(iii)(D). Thus, the royalty payment has an effect on consolidated taxable income.

Parent's position is that the attributes of Sub's intercompany item and Parent's corresponding item do not match on a separate entity basis. Parent argues that the reason for the mismatch is because Parent's income is earned through the export of goods through a FSC. Under the FSC provisions, Parent is entitled to deduct a FSC commission expense. In computing combined taxable income on which the FSC commission is based, Parent must reduce the amount of combined taxable income by a portion of the royalty payment. However, no portion of the royalty payment received by Sub is included in computing combined taxable income. The reason for the non-inclusion is two-fold. First, the royalty payment would not constitute foreign trading gross receipts under section 927(a)(2)(B), and, second, Sub is not a related supplier. However, this inconsistent treatment of the same item for income and expense purposes effectively results in a character mismatch and should be redetermined under § 1.1502-13(c)(4). If Parent and Sub were divisions, there would be no royalty expense to allocate to foreign trading gross receipts, and, thus, there would be no corresponding reduction in Parent's FSC commission deduction under § 1.925(a)-1T(c)(6)(iii)(D). Parent would still have the same foreign trading gross receipts, but there would be no royalty payment. Moreover, Parent contends that if the intercompany payment had been interest, then § 1.861-11T, which specifically addresses interest expense within an affiliated group, would not require that either the interest income or the interest expense be included in the combined taxable income computation. However, § 1.861-11T does not apply to deductions other than interest and is, therefore, inapplicable in this case. In view of the mismatch, Parent concludes that under § 1.1502-13(c)(4) the attributes of the licensing agreement and the corresponding export sale should be redetermined to reach the single entity result.

It is not inconsistent with the FSC rules or § 1.1502-13 to redetermine the attributes of Sub's royalty income that corresponds to Parent's foreign trading company gross receipts. Accordingly, based solely on the facts and information submitted, it is held as follows:

> Solely for purposes of applying § 1.1502-13(c)(4)(i)(A) to this transaction, a portion of Sub's royalty income is to be redetermined as foreign trading gross receipts under § 1.1502-13(c)(4)(i)(A) of the Income Tax Regulations. Otherwise, royalty income generally does not qualify as foreign trading gross receipts because the underlying

property is not export property as defined under section 927(a)(2)(B) of the Internal Revenue Code.

No opinion is expressed about the tax treatment of the transaction under other provisions of the Code and Regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transactions that are not specifically covered by the above ruling.

This ruling is directed only to the taxpayers who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax return of the taxpayers involved for the first taxable year in which the intercompany transaction covered by this ruling is consummated.

Pursuant to the power of attorney on file in this office, a copy of this letter has been sent to your authorized representative.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By Edward S. Cohen
Edward S. Cohen
Chief, Branch 2

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